

TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Alternative Investment - Dual Role of
Consultant/Advisor

ITEM NUMBER: 6

ATTACHMENT(S): 1

ACTION: _____

DATE OF MEETING: Sep. 2, 1998

INFORMATION: X

PRESENTER(S): Mr. Mitchell

EXECUTIVE SUMMARY

One of the 1998/99 Investment Branch objectives was to "Evaluate the dual role of advisor and consultant. The Staff would then present a recommendation to the Investment Committee on the appropriate structure."

Analysis and factual circumstances make the evaluation of the dual role of consultant/advisor complex. Multiple services are required to manage STRS' alternative investment program. These services can be provided by a single entity or multiple entities, internal or external. When a single entity provides multiple services to a client, there is a potential conflict which may affect or alter behavior patterns.

For background, a synopsis of the history of the STRS' alternative investment program and a summary of the services provided by Pathway Capital Management under the existing alternative investment "advisor" contract is provided in Attachment 1.

To assist the Board in its evaluation of the issues, staff developed a brief definition of terms "consultant", "advisor", and "manager". To create these definitions staff reviewed the existing advisory contract and surveyed a variety of parties for input including:

- A. Alternative Investment Advisor -- Pathway Capital Management
- B. General Consultant -- Pension Consulting Alliance
- C. Peer Pension Plans -- California PERS, Utah PERS, Minnesota Investment Board
- D. Academic Experts -- Harvard Business School

As a result of the information obtained via survey and interview, four findings are summarized on page four of Attachment 1. These findings serve as the basis for three policy alternatives for the Investment Committee consideration. These alternatives are:

1. Continue current policy
2. Create a dual consultant and advisor structure
3. Internalize the advisory function

Staff has not observed any detriment resulting from potential conflicts identified in this report. Staff recommends continuing the current policy of utilizing an external consultant/advisor with oversight provided by STRS' staff.

BACKGROUND

The decision to invest in an alternative investment program was made after receiving a positive recommendation from the general pension consultant as part of a comprehensive asset allocation study. The strategy was to invest in limited partnerships including venture capital, leveraged buyouts, and special situations. In 1987, the Teachers' Retirement Board chose to contract with an alternative investment consultant to develop the alternative investment policy and procedures.

The current alternative investment advisor (Pathway Capital Management) was hired in April 1997. A synopsis of the services to be provided is identified below:

1. Research and present new strategies for Board consideration.
2. Provide advice on market general conditions, including positive and/or negative trends.
3. Screen the general universe of investments and recommend those meeting STRS' selection criteria and provide recommendations on investment proposals.
4. Conduct in-depth analyses, background checks, and due diligence reviews of prospective general partners and/or co-investments.
5. Make written recommendations to STRS' investment staff on prospective partnerships and/or co-investments.
6. Assist STRS' staff in the negotiation of terms and conditions of partnerships and/or co-investments.
7. Monitor the performance of the partnership investments and/or co-investments made; And provide quarterly and annual review reports on an absolute and relative basis.
8. Maintain access to legal counsel acceptable to STRS with expertise in limited partnerships and/or co-investments, and other privately placed security transactions. Such counsel must be available to assist in the negotiations with issuers.
9. Maintain a database sufficient in size and scope to allow an analysis of the returns of private equity partnerships and privately placed securities, diversified by size, industry, geography, type, and stage of financing.
10. Attend all STRS Investment Committee/Board meetings or legislative hearings including a semi-annual presentation on alternative investments for the STRS Board.

DEFINITION OF TERMS

Between asset classes, some terms have been used interchangeably such as “advisor/manager” or “advisor/consultant”. This has led to confusion. To provide clarity for analysis purposes, staff defined the terms consultant, advisor, and manager. The following definitions were determined:

Consultant -- Providing professional advice on policy development, policy monitoring, performance computation and reporting, general and market research, and manager selections. The consultant’s advice is limited to portfolio related issues. The relevant services are numbers 1, 2, 7, 9, and 10 which have been listed on the previous page.

Advisor -- To provide suggestions or advice to staff or Board (no discretion for decision making purposes) on individual investment selections and/or limited partnerships. The advisor’s role is less distinct between portfolio related issues and individual security selection issues, but leans toward individual transactions. The relevant services are 3, 4, 5, 6, and 8 which are listed on the previous page. In real estate this role is occupied by an independent fiduciary.

Manager -- To complete investment decisions for individual investment selections and/or limited partnerships with a predetermined amount of discretion regarding: allowable purchases, prohibited transactions and trading restrictions as contained in the investment guidelines. The manager’s role is to add value through security selection and market timing.

ISSUES

Does the unique character of the alternative investment asset class coupled with the use of a combination of internal and external professionals require a division of the consultant/advisor responsibilities?

In completing the research for this presentation, staff contacted a variety of parties for input and analysis including Pathway Capital Management, Pension Consulting Alliance, California PERS, Utah PERS, Minnesota Investment Board and Harvard Business School.

As a result of the information obtained via an informal survey and interview, one element to consider is number and variety of services provided by the consultant/advisor. When the consultant/advisor generates fee income from multiple and possibly competing sources it creates a potential conflict. Activities which generate fee income such as fund of funds,

discretionary accounts, and/or multiple advisory relationships create unique potential conflict issues.

One risk identified by each of the parties interviewed centered on the issue of allocation of limited partnerships. If a consultant/advisor offers a fund of funds or has discretionary accounts with acquisition or performance fees, there is a potential for conflict when allocating a commitment to a partnership with high expected returns. This risk is mitigated because STRS' staff works directly with the general partners to negotiate the actual allocation.

Another risk is in the evaluation of partnerships, where the consultant may be less than objective in evaluating partnerships that they previously recommended. This risk is mitigated by staff closely monitoring all partnership commitments and fundings. Staff has created a tiering system to be used in conjunction with the consultant's evaluation.

FINDINGS

As a result of the information obtained via survey and interview, four findings have been summarized below:

1. The services listed on page one of this report including completing due diligence and making recommendations on individual partnerships are necessary for the success of the STRS alternative investment program.
2. A majority of pension funds engaging in alternative investments operate without an external alternative investment consultant or advisor. STRS uses a unique structure of staff, advisor, manager, and consultant services. In the general public fund universe, there are two primary methods of approaching an alternative investment program: (1) Using an external manager on a discretionary basis with limited oversight provided by staff or general consultant, or (2) Using staff without an external consultant/advisor with limited oversight provided by the general consultant.
3. The survey revealed that no major pension fund has taken action to divide the role of consultant/advisor and subsequently hired an external consultant and an external advisor for alternative investments. A primary reason given was the potential problems arising from two competitors working on the same portfolio forced to share proprietary information on due diligence, partnership analysis, and contract negotiations.
4. The more reliant a consultant/advisor is on multiple sources of fee generation activities such as fund-of-funds, discretionary accounts, and partnership universe creation the higher the potential for a conflict affecting behaviors.

In regards to alternative investments, no careful study or research has been completed regarding the conflicts that exist or if these conflicts affect or alter behavior patterns. Potential conflict issues will occur, however, in most instances can be mitigated by involvement and oversight. The quality of the oversight is dependent on the knowledge and independence of the staff.

POLICY ALTERNATIVES

Considering the requirements of the STRS' alternative investment program within the context of this limited investigation, three alternatives have been provided to the Investment Committee for consideration:

1. Continue current policy -

The current structure has the potential for conflict, however, limited research has been completed regarding if a conflict affects or alters behavior patterns. Additionally, potential conflict issues, in most instances, can be mitigated to an acceptable level of risk by involvement and oversight of knowledgeable and independent staff..

2. Create a dual consultant and advisor structure -

Contract with two external entities with a consultant responsible for providing professional advice on policy development, policy monitoring, performance computation and reporting, and general research. The consultant's advice is limited to portfolio related issues. The advisor would be responsible for providing suggestions or advice to staff or Board (no discretion for decision making purposes) on individual investment selections and/or limited partnerships. There are practical difficulties with the implementation of this alternative.

3. Internalize the advisory function -

Eliminate external involvement in the due diligence, evaluation, and selection processes for individual investments or partnerships. Continue external consulting for policy development, policy monitoring, performance computation and reporting, and general research. This would eliminate the "dual review" currently completed by staff and consultant/advisor. It would be necessary to add a minimum of three individuals including one attorney to internalize the advisory function.

Staff has not observed any detriment resulting from any of the identified conflicts. Staff would recommend continuing the current policy of utilizing an external consultant/advisor with oversight provided by STRS' staff.